

Western Asset US High Yield Sector

This is a marketing communication.

Key Takeaways

- The Bloomberg US High Yield 2% Issuer Cap Index returned 2.54% in the third quarter.
- Spreads tightened by 23 bps in the third quarter to 267 bps and the YTW decreased to 6.70%.
- Both BB rated and B rated bonds underperformed the index, returning 2.31% and 2.28%, respectively, while CCC rated bonds returned 4.37%.
- High-yield issuance totaled \$122 billion for the quarter, bringing YTD issuance to \$267.5 billion (58% higher QoQ and 13% higher YoY).
- High-yield funds saw inflows of \$5.0 billion for the quarter, bringing YTD flows to \$14.9 billion (compared to inflows of \$14.9 billion for the same period a year ago).
- We are still seeing opportunities in rising-star candidates, and have and will continue to selectively utilize the primary market at attractive concessions.
- We maintain a deep bias to cyclicals given strong fundamentals and the attractive yield pickup versus noncyclicals, along with key overweights to financials, copper producers and E&P within the energy sector.

Market Review

During the third quarter, volatility in both equity and Treasury markets remained relatively subdued. The US Treasury yield curve bull-steepened, reflecting market expectations for slower growth, moderation in economic data and potential rate cuts. Risk assets performed well, with the S&P 500 Index reaching new highs and credit spreads tightening.

US job growth weakened in August, with nonfarm payrolls rising by 22,000 jobs—lower than July's upwardly revised figure of 79,000 (from 73,000). The unemployment rate edged up to 4.3% from 4.2% over the quarter. Over the last three months, headline CPI increased to 2.9% year-over-year (YoY) from 2.4%. Core Personal Consumption Expenditures (PCE), the Federal Reserve's (Fed) preferred inflation measure, which excludes food and energy, rose to 2.9% YoY, up from 2.7% over the previous three months.

For the first time since December 2024, the Federal Reserve Open Market Committee (FOMC) lowered its policy rate by 25 basis points (bps) at its September meeting, setting the target range for the fed funds rate at 4.00% to 4.25%. While the move itself was not surprising, a recent string of significantly weaker labor market data, alongside mounting political pressure for a larger cut, made communication particularly important for a market already pricing in a series of additional rate reductions. In the Summary of Economic Projections (SEP), the median committee member anticipated a total of 75 bps of cuts in 2025 (including the September rate cut), compared to 50 bps projected in the June SEP. Notably, seven of the 19 members now foresee no further rate reductions this year, indicating a stark division within the committee.

During the third quarter, the Bank of England (BoE) cut its policy rate by 25 bps to 4.0%, as expected. However, a hawkish vote split and a forecast for a higher peak in inflation later in the year led the market to price in a slower pace of future easing. In its annual decision on

quantitative tightening, the 12-month envelope for balance sheet reduction was lowered to £70 billion from £100 billion last year, with active sales skewed away from longer-dated maturities. The European Central Bank (ECB) held its policy rate unchanged at 2.0%, as expected. ECB President Christine Lagarde reiterated that the current policy setting is "in a good place," with inflation close to the ECB's 2% target and an upward revision to this year's growth forecast as uncertainty around US trade tariffs has declined.

Within the global high-yield market, spreads tightened by 25 bps to end the third quarter at 307 bps, based on the Bloomberg Global High Yield USD Hedged Index. The yield-to-worst of the index decreased to 6.77%. The top-performing industries were energy, communications and transportation, while basic industry, technology and capital goods were the worst-performing sectors. High-yield issuance totaled \$122 billion for the quarter, bringing year-to-date (YTD) issuance to \$267.5 billion (13% higher YoY). High-yield funds saw inflows of \$5.0 billion for the quarter, bringing YTD flows to \$14.9 billion (compared to inflows of \$14.9 billion for the same period a year ago), according to JPMorgan.

Outlook

Western Asset's outlook remains constructive, though we recognize that growth momentum is tempered by uncertainty in areas such as inflation, central bank policy, geopolitics and fiscal sustainability. US financial conditions are largely supportive, which, alongside fiscal loosening and solid household balance sheets, points toward a positive foundation for growth. Headwinds remain, including doubts over the state of the US labor market, core inflation lingering close to 3% and the potential lagged impact of tariffs. This backdrop should keep the Fed on a rate-cutting path, albeit with a cautious view of the inflation outlook. Fiscal vulnerabilities and persistent inflation may see the yield curve steepen

further. European growth is expected to benefit from German and EU fiscal support with the ECB judging the eurozone economy to be “in a good place.” The EU’s trade deal with the US has not boosted confidence, however, and unemployment is rising in Germany and France. The French government’s inability to agree and ratify a budget is likely to have a significant bearing on risk-sentiment toward French and peripheral European assets. Japanese politics are also in sharp focus, with the new leader of the LDP expected to be elected prime minister and shift toward more expansionary fiscal policy. Chinese GDP growth is marginally below the prescribed 5% target, but with inflation rebounding from the 2024 lows and the government offering fiscal and regulatory support, monetary policy is not expected to be loosened further in the near term. While we retain a modest overweight to interest-rate duration, we are concentrated in shorter maturities and biased to select countries and regions such as core Europe and the UK. While fundamentals remain positive, spreads are at the tight end of historical ranges in many sectors and warrant caution. We will continue to look for further periods of volatility to add to spread risk.

An actively managed high-yield strategy yielding around 7.25% with an option-adjusted spread of 322 bps above the riskless rate remains attractive compared to equities and other higher-volatility alternatives

given the current macro backdrop and sound fundamentals. Today’s spreads offer an ample premium in excess of default risk, with our expectations for default rates to track around 4% on an issuer-weighted basis and 2% on a par-weighted basis. Leverage and interest coverage ratios for high-yield issuers have shown resilience, with healthy balance sheets and conservative management team behavior evident as growth slows. From a technical perspective, we expect continued demand to persist from both institutional and retail investors as they search for steady income generation in their portfolios. A significant increase in M&A activity has provided additional tailwinds for the asset class and should continue to benefit high-yield issuers as scale is created and/or takeouts by investment-grade credits lead to material spread compression. Importantly, with an extremely robust primary calendar clearing YTD, over 70% of that deal flow has been for refinancing purposes addressing near-term maturity walls. We have and will continue to selectively utilize the primary market at attractive concessions. In terms of subsector positioning, we maintain a deep cyclicals bias given the yield pickup versus noncyclicals and the strong fundamentals we are seeing there, along with key overweights to cruise lines, airlines, copper producers and midstream companies within the energy sector.

Risk Disclosures

All investments involve risks, including possible loss of principal. Fixed-income securities involve interest rate, credit, inflation, and reinvestment risks; and possible loss of principal. As interest rates rise, the value of fixed-income securities falls. International investments are subject to special risks, including currency fluctuations and social, economic and political uncertainties, which could increase volatility. These risks are magnified in emerging markets. Asset-backed, mortgage-backed or mortgage-related securities are subject to prepayment and extension risks. High yield bonds are subject to greater price volatility, liquidity, and possibility of default.

The **Bloomberg US High Yield 2% Constrained Index** is a component of the U.S. Corporate High-Yield Bond Index, which covers the universe of fixed-rate, non-investment-grade corporate debt of issuers in non-emerging market countries. It is not market capitalization-weighted; each issuer is capped at 2% of the index.

Bloomberg US High Yield—2% Issuer Cap USD Unhedged Index is an issuer-constrained version of the flagship US Corporate High Yield Index, which measures the USD-denominated, high yield, fixed-rate corporate bond market. The index follows the same rules as the uncapped version, but limits the exposure of each issuer to 2% of the total market value and redistributes any excess market value index wide on a pro rata basis.

The **Consumer Price Index (CPI)** tracks prices for a basket of more than 80,000 goods and services.

Credit quality is a measure of a bond issuer's ability to repay interest and principal in a timely manner. The credit ratings discussed are based on a security's rating as provided by Standard and Poor's, Moody's Investors Service and/or Fitch Ratings, Ltd., and they typically range from AAA (highest) to D (lowest), or an equivalent and/or similar rating. The credit quality of the investments in a fund's portfolio does not apply to the stability or safety of the fund. These ratings are updated monthly and may change over time. Please note that the closed-end funds have not been rated by an independent rating agency. Investment-grade bonds are bonds that are rated Aaa, Aa, A and Baa by Moody's Investors Service and AAA, AA, A and BBB by Standard & Poor's Ratings Service, or that have an equivalent rating by a nationally recognized statistical rating organization or are determined by the manager to be of equivalent quality. A below-investment-grade bond or high-yield security has a rating of BB or lower; it pays a higher yield to compensate for its greater risk.

The **Fed Funds Rate** is the interest rate at which depository institutions trade federal funds (balances held at Federal Reserve Banks) with each other overnight.

Gross domestic product (GDP) is an economic statistic that measures the market value of all final goods and services produced within a country in a given period of time.

High-yield bonds possess greater price volatility, illiquidity and possibility of default.

Investment-grade bonds are generally rated BBB and above.

The **S&P 500 Index** is an unmanaged index of 500 stocks that is generally representative of the performance of larger companies in the U.S.

Spread refers to the difference between Treasury securities and non-Treasury securities of similar maturity but different credit quality.

Summary of Economic Projections are released by the Federal Reserve four times a year. SEP features the Federal Open Market Committee (FOMC) participants' projections for GDP growth, the unemployment rate, inflation and the appropriate policy interest rate.

U.S. Treasuries are direct debt obligations issued by the U.S. government and backed by its "full faith and credit." The U.S. government guarantees the principal and interest payments on U.S. Treasuries when the securities are held to maturity.

Yield to worst (YTW) is based on a portfolio's current holdings on one specific day, is gross of all portfolio expenses, and is calculated based on assumptions that prepayment occurs if the bond has call or put provisions and the issuer can offer a lower coupon rate based on current market rates.

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